

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Contact Person: [REDACTED]

Telephone Number [REDACTED]

In Reference to [REDACTED]

Date: NOV 20 1998
OP:E:EO:T:3

EIN: [REDACTED]

Key District Office: [REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(c)(3) of the Internal Revenue Code (Code). Based on the information submitted, we have concluded that you do not qualify for exemption under that section.

The [REDACTED] government enacted a state law codified as [REDACTED], titled [REDACTED]. The preamble to the statute provides that it is an essential function of state government to provide basic support for persons with mental or physical impairments. The preamble continues with the recognition that cost of providing basic support for disabled persons is difficult for many citizens to afford, and they must rely on government support. Continuing, the preamble provides that it is necessary and desirable for the public health, safety and welfare of the citizens of the state to encourage, enhance and foster the ability of family members and friends of disabled persons to supplement, but not to replace, the basic support by state government and other governmental programs and to provide for medical, social, or other supplemental services for those persons with impairments. (Emphasis added).

The problem is explained by the brochure of your organization. If a person were to leave a trust fund at death or during life, to a disabled child or relative, the existing law would require that the disabled person be taken out of the state institution where he was residing and use the assets of the trust for living expenses until consumed, and then the disabled person would return to the state facility for his continued support. This frustrates the intent of the parent to provide the child with supplementary support while, perhaps, retaining some of the remainder in the trust for another child who is not disabled. The [REDACTED] law solves this dilemma.

The family relative may leave assets in trust with a life income payment to the disabled relative to supplement the support

received by the child under the state and other governmental programs. This technique is also effective where the disabled person himself receives the funds from a judgement or settlement in a law suit. In either case, the disabled person does not forfeit basic care. The supplemental funds can be used for supplemental education, private rehabilitation, entertainment, medical and diagnostic treatment beyond Medicare, and the purchase of furniture for a group home.

Under this law the [REDACTED] must be sponsored by a nonprofit corporation, and the trustees are required to have experience in business, finance, investment management, and providing services to persons with disabilities. An eligible beneficiary must have a disability that substantially limits one or more major life activities. You, [REDACTED], are the only community trust in the state. You are sponsored by [REDACTED], an organization exempt under section 501(c)(3) of the Code with an exempt purpose of operating a charitable mental health center offering services for inpatient and out patient treatment. [REDACTED] is also supported by other mental health organizations in the area.

[REDACTED] is considered one trust for investment and management purposes. Individual beneficiaries of the fund have separate accounts to which net income is credited in proportion to each beneficiary's contribution. The proportion changes according to expenditures allocated to individual beneficiaries. It should clearly be understood that you are making no assertion that the individual funds are assets of [REDACTED] or are part of your organization either for tax or accounting purposes. [REDACTED] clearly acknowledges that for legal and tax purposes, the individual accounts are separate taxable trusts, taxable to the income beneficiary under sections 678 or 673 of the Code. [REDACTED] only serves as a manager of the funds and oversees the expenditures on behalf of the disabled person. A family member or other interested party is named as an advisory co-Trustee in order to advise the trustees of the fund as to the needs of the income beneficiary. Thus, the primary exempt purpose of [REDACTED] is to offer a management service to disabled persons.

One of the most important provisions of the law and the trust document established thereunder is [REDACTED]. The co-trustee (i.e., the advisory trustee) and the [REDACTED] Trustees annually, or more frequently, shall agree on the amount of income or principal, or both, to be used to provide noncash benefits and the nature and type of benefits to be provided to the life beneficiary. Any income which is not used shall be added annually to the principal.

██████████ is supported by grants from ██████████ and from fees charged to trust accounts. ██████████ charges a one-time enrollment fee of \$██████████ and an annual fee of \$██████████ except that the annual fee cannot exceed the income of the account. It is asserted that such fees are substantially below the cost that would be charged by a private bank to administer the funds. It is stated that commercial banks generally will not manage a trust for an amount less than \$██████████ and the annual fee is generally ██████████ percent of the trust assets (\$██████████). Under such assumptions, the fee of ██████████ is ██████████ percent less than the fee of the commercial bank. It is also asserted that commercial banks may not be as knowledgeable concerning these types of trusts benefitting disabled person; such as regulations with respect to Medicaid, SSI, etc. Generally, banks will not deal with low income people so they do not have knowledge of these subjects. ██████████ has a thorough knowledge of these subjects.

██████████ will serve all disabled persons (or relatives) who request the service. The only requirement is that the disabled person meet the state law definition. State law does require that the community trust be qualified as tax-exempt under the Internal Revenue Code. State law requires that the community trust accept contributions from any source.

One of the troubling aspects of ██████████ and the manner in which ██████████ will be operated is that the trust funds or accounts are not necessarily irrevocable, and any particular trust fund may either be revoked by a private interest (not a disabled person) or the remainder interest in the trust may pass to a private individual who is not a disabled person.

If the donor designates himself or herself or his or her spouse as life beneficiary, then the account of the life beneficiary shall be irrevocable; ██████████. The remaining funds in the account at the life beneficiary's death shall be distributed to the "successor trust." The successor trust is a fund which is owned and held by ██████████ for disabled persons who are indigent. The Successor trust is a fund legally owned by ██████████. Its assets are assets of ██████████ and its income is tax-exempt. It is not used for or on behalf of persons named in trust accounts.

During his or her lifetime, a donor who has not designated himself or herself or his or her spouse as the life beneficiary may revoke any contribution made to a community trust. Any co-trustee other than the donor, for good and sufficient reason upon written notice to the trustees and upon the approval of such trustees, may withdraw all of the current fair market value of the balance of the life beneficiary's account in the trust held

[REDACTED]

by the community trust. In the event of withdrawal, the funds shall be distributed to the donor.

If a life beneficiary for whose benefit a contribution has been made to the trust ceases to be eligible to participate in the trust, the trust funds may be distributed to the person designated by the donor, assuming no revocation by the donor or withdrawal by the co-trustee. If there is no revocation, withdrawal or designation by the donor, the funds shall be distributed to the successor trust.

Upon the death of the life beneficiary, an amount equal to the current fair market value of the balance of the life beneficiary's account in the trust shall be distributed to the person or persons the donor has designated. If the donor has failed to designate a person or persons or if distribution to such designated persons is impossible, the funds shall be distributed to the successor trust.

[REDACTED] has submitted with this application a document titled "[REDACTED]". This document is the prototype master trust agreement for carrying out the provisions of [REDACTED]. The agreement contains the following provision:

The Advisory Co-trustee shall have no authority over the management or administration of the trust and shall have no authority to require distributions, but shall act solely in an advisory capacity to the Board of Trustees on the needs of the Life Beneficiaries. In the event of a donation otherwise acceptable to the Board of Trustees, but without the designation of an Advisory Co-Trustee, or when an Advisory Co-Trustee fails to serve and no successor has been designated by the Donor, the Board of Trustees may appoint an Advisory Co-Trustee.

Also submitted with the application is a document titled "[REDACTED]". The purpose of this document appears to be similar to a signature card in opening a bank account with a commercial bank. [REDACTED] identifies the donor and the donor's adoption of the [REDACTED] on behalf of the life beneficiary. Thus, the life beneficiary is also identified along with various information relating to the life beneficiary. The joinder agreement establishes the time at which the trust is to become effective and the manner of its funding. It identifies any potential remainder beneficiaries who may receive the trust corpus after the life beneficiary's death. [REDACTED] contains the following sentence:

[REDACTED]

The donor recognizes that all distributions are at the Trustee's discretion. With this in mind, the Donor expresses the following desires as to how funds in the trust sub-account might be used.

[REDACTED] it then goes on to list 6 specific type of expenditures on behalf of the disabled person and the leaves a blank space for "other" so that the donor can add some purpose not listed by the document.

The trustee of the successor trust shall hold, administer, and distribute the principal and income of the successor trust, in the discretion of the trustee, for the maintenance, support, health, education, and general well-being of indigent persons suffering from one or more impairments, which is to supplement, not replace, any government benefits for the beneficiary's basic support.

[REDACTED] will have a professional investment advisor. The [REDACTED] brochure advises prospective donors that the contributions to the trust are not deductible as charitable gifts or otherwise. Further, the brochure advises donors that contributions will have little effect on estate, gift, and death taxes because the amount of money in their estate will be below that subject to substantial taxation.

[REDACTED] does not expect to receive any income from [REDACTED] for services rendered to [REDACTED] nor does it expect to be reimbursed for the grants made to [REDACTED]. There will not be any contracts between [REDACTED] and [REDACTED] relating to services to be provided to [REDACTED]. The Trustees of [REDACTED] are all members of the community who are not financially interested in the activities of [REDACTED] or [REDACTED] except [REDACTED].

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations organized and operated exclusively for one or more of the purposes specified therein.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations (Regulations) provides that an organization must be both organized and operated exclusively for one or more of the purposes specified in section 501(c)(3) of the Code in order to be exempt as an organization described in such section. If an organization fails to meet either the organizational or the operational test, it is not exempt.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for exempt purposes only if it is engaged primarily in activities which accomplish purposes specified in section 501(c)(3). An

organization will not be so regarded if more than an insubstantial part of its activities does not further an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations states that an organization is not organized or operated for exempt purposes unless it serves a public rather than a private interest. Accordingly, the organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, its creator, shareholders or persons controlled, directly or indirectly, by such private interests.

In Better Business Bureau v. United States, 316 U.S. 279 (1945), the Supreme Court considered the meaning of "exclusively" in an exemption provision similar to section 501(c)(3) of the Code. The Court held that the existence of a single non-exempt purpose, if substantial in nature, will destroy the exemption under section 501(c)(3).

Although a 501(c)(3) organization may provide benefits to private individuals, those benefits must be incidental quantitatively and qualitatively. To be qualitatively incidental, private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals, *i.e.*, it must be impossible for the organization to accomplish its purposes without providing benefits to private individuals. *See, e.g.*, Rev. Rul. 70-186, 1970-1 C.B. 128. To be quantitatively incidental, the private benefit must be insubstantial, measured in the context of the overall public benefit conferred by the activity. *See, e.g.*, Rev. Rul. 68-14, 1968-1 C.B. 243; Rev. Rul. 75-286, 1975-2 C.B. 210; Rev. Rul. 70-186, *supra*; and Ginsburg v. Commissioner, 46 T.C. 47 (1966).

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the Tax Court concluded that an organization that conducted a school for training in political campaign operations was not described in section 501(c)(3) because it benefitted the private interests of Republican entities and candidates more than incidentally. The court concluded that the conferral of benefits on disinterested persons may cause an organization to serve a "private interest" within the meaning of section 1.501(c)(3)-1(d)(1)(ii).

In Rev. Rul. 76-152, 1976-1 C.B. 152, the Service held that a nonprofit organization formed by art patrons to promote community understanding of modern art trends by selecting for exhibit, exhibiting, and selling art works of local artists,

retaining a commission on sales less than customary commercial charges and not sufficient to cover the cost of operating the gallery, does not qualify for exemption under section 501(c)(3) of the Code.

In Rev. Rul. 75-286, 1975-2 C.B. 210, the Service held that a nonprofit organization with membership limited to residents and business operators within a city block and formed to preserve and beautify the public areas in the block, thereby benefiting the community as a whole as well as enhancing the members' property rights, will not qualify for exemption under section 501(c)(4). The Service found that the organization served the private interests of its members by enhancing the value of the members' property rights.

The community trust serves a mixed charitable and private purpose. To the extent that the management of the trust serves the benefit of persons described by the statute as impaired, that is, disabled, the management activities would be deemed as serving a charitable purpose. Activities benefitting the handicapped or disabled person have been held by the Service to be an exempt activity in a number of situations. See Rev. Rul. 79-19, 1979-1 C.B. 195; Rev. Rul. 75-472, 1975-2 C.B. 208.

However, the management activities of your organization benefit private individuals in a number of situations. If the donor who is not a life beneficiary revokes the trust, he benefits from the low cost management of the trust by your organization. If the donor who is not a life beneficiary receives the trust principal upon the request of the co-trustee for the withdrawal of the trust, he similarly receives the benefit of the management of the trust by your organization. Finally, if a person receives the trust principal as the designated remainder beneficiary after the death of the life beneficiary, such remainder beneficiary benefits from the low cost management of the trust by your organization. Further, there is the possibility, however remote, that a co-trustee may act to intentionally limit the amount of distributions to the life beneficiary in order to benefit himself or his relative who is designated as a remainder beneficiary.

The activities of your organization constitute a conferral of a private benefit on noncharitable parties thereby causing your organization to serve private interests within the scope of the holding in American Campaign Academy v. Commissioner, *supra*. As such, your organization fails to serve a public rather than a private interest. See section 1.501(c)(3)-1(d)(1)(ii) of the Regulations.

[REDACTED]

The private interest being served is more than incidental. It has been asserted that the property interest of the designated beneficiary who receives the trust on the death of the life beneficiary is only a contingent remainder interest since the trust may be fully expended to benefit the life beneficiary. While this may be true, the brochure put out by your organization uses an example, which may be seen as a model for the operation of the community trust, where the remainder interest of the son, [REDACTED] passes to him on the death of the life beneficiary. See [REDACTED] of the brochure.

The private benefit conferred on the artist in Rev. Rul. 76-152 is not unlike the private benefit conferred in this case in that in both cases the recipient (the private interest) has no control over whether any value will be received. The private benefit discussed in Rev. Rul. 75-286 is in some ways analogous to this case in that the property value of private individuals is being enhanced by the activities of the organization, even though the organization, like your organization, also serves a public interest.

In summary, the benefit that may be received by either the donor or the designated remainder beneficiary is more than incidental. It is substantial in relation to the public interest being served. Accordingly, we conclude that you are not operated exclusively for charitable purposes within the meaning of section 501(c)(3) of the Code and the regulations thereunder.

Since you do not meet the "operational test" requirements of the Code, you do not qualify for recognition of exemption from income tax under section 501(c)(3) of the Code.

Contributions to you are not deductible under section 170 of the Code.

You are required to file federal income tax returns.

You have the right to protest this ruling if you believe that it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement must be submitted within 30 days of the date of this letter and must be signed by one of your officers. You also have a right to a conference in this office after your statement is submitted. If you want a conference, you must request it when you file your protest statement. If you are to be represented by someone who is not one of your officers, he/she must file a proper power of attorney and otherwise qualify under our Conference and Practice Requirements.

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If you do not protest this proposed ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the United States Tax Court, the U.S. Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key District Director. Thereafter, any questions about your federal income tax status should be addressed to that office. The appropriate State officials will be notified of this action in accordance with section 6104(c) of the Code.

Sincerely yours,

~~Kenneth J. Earnest~~
Kenneth J. Earnest
Acting Chief,
Exempt Organizations
Rulings Branch 3

Code	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer	Reviewer
	OP: E. E. T. 13	OP: E. E. T. 13					
Surname							
Date							